nerej
CELEBRATING 55 YEARS

President's message: Capital market's impact on real estate

September 12, 2007 - Financial Digest

The booming investment sales market could not last forever. Flipping properties and largely debt-financed purchases of trophy properties will be more difficult in the current credit crunch. However, the credit crunch has come about at a time when the market can handle such a shift without disaster. With the credit crunch hitting all aspects of the investment world, commercial real estate is still a comparably attractive investment vehicle for many buyers.

Institutions and equity funds are flush with capital from fund raising in the first half of the year. Since these investors are not as reliant on leverage, they will still be able to move forward with investments in commercial real estate. In fact, these investors will be able to compete on more deals, as their highly leveraged competitors drop out of bidding. Sellers who seek out these buyers can be more confident that their deals will come to fruition.

This does not mean that all other investors are out. As sources of low rate lending dried up, many deals were not canceled, but rather postponed. Sellers and buyers alike are showing a cautious optimism that the debt market will steady itself in the not too distant future, and renegotiated deals will still go forward. According to Real Capital Analytics, the number of transactions reported as under contract nationally increased $3 billion in the past month. The Fed's position increases the likelihood of the debt market stabilizing quickly. Bernanke wrote to Senator Chuck Schumer that he would act "as needed" to steady the economy and calm the debt market. After the August 17th drop in the Fed discount rate, all eyes are on the possibility of further cuts and a deduction in the federal funds rate.

Risky Business

But what is at the root cause of the crunch? It is not just the subprime mortgage fiasco. That was a symptom of a much more widespread market phenomenon: ignoring risk. It is easy to ignore risks when the market is thriving, but the subprime mortgage situation shows that it cannot go on forever. Shawn Tully of Fortune Magazine calls the credit crunch a "massive repricing of risk in every asset class." Reassessing risk now while the market is strong in other areas may prevent a collapse in the future. The reconsideration of commercial real estate deals is seen by some as a necessary market correction, instead of a market downturn. In Boston, this correction now will mean a slowdown from the breakneck speed of recent transactions.   David Geltner, director of the MIT Center for Real Estate, thinks a there is a "low probability" of a market collapse and a "leveling off" is much more likely. This correction could have a stabilizing effect on the market in the longer term.

Investment sales can have drastic cyclical swings. This credit crunch might prevent the market from reaching a new height, but it could also be the key to preventing the next deep trough.

Back to Basics

As deals with lower and lower cap rates and record setting prices heated a competitive market, risk was overlooked. Now investors may have to go back to fundamentals. With prices expected to plateau, investors will no longer be able to depend on a quick turnaround and increasing sales prices for their returns. More reliable operating income may become increasingly enticing as investors realize the market's new dynamics, as well as the higher cap rate required to purchase properties. In Greater Boston, the trend of increasing rents and decreasing vacancies is unlikely to stop until new product comes on the market. Many new projects in the suburbs were financed before the debt market correction and will be coming to market in the next year. In downtown Boston, the credit crunch could keep vacancies lower for even longer as some developers push back new office projects until the debt market has settled. Keeping a tight market tight longer will support strong fundamentals for institutional investors still willing to play ball.

The current uncertainty within the capital markets and the potential impact on commercial real estate underscores the importance of the appraisal profession. The members of the Appraisal Institute will be relied upon for the valuation of billions of dollars of real estate over the coming months, reflecting our dominant position as the world's most prominent appraisal organization.

Patrick Cavanagh is president of the Massachusetts Chapter of the Appraisal Institute, Boston.